

## Challenges of Globalization: Imbalances and Growth

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The last three decades of economic, social, and political development in the world have been nothing short of spectacular. Japan rose to become a great economic power after its defeat in World War II. Its success was followed by rapid growth in the East Asian Tigers—Hong Kong, Singapore, Taiwan, and South Korea. Thanks to Deng Xiaoping's reforms in 1978, China has risen to become a global economic superpower. India is growing at a similar speed, with the former Soviet bloc joining in the growth feat, reaching an annual average growth rate of 9 percent in recent years.

However, one of the greatest global booms ever is now ending following the eruption of a financial crisis that began in the United States and may spread to other regions. Global imbalances, exceedingly accommodative monetary policy and loose regulation have caused the current US financial crisis and global overheating, which has resulted in surging commodity prices and global inflation. In many countries, reform fatigue has followed the reform impetus of the 1990s. The current round of multilateral trade negotiations in the World Trade Organization, the Doha Round, is paralyzed.

A major macroeconomic concern derives from the inordinate imbalances in international payments. China, Japan, Russia, and East Asian and oil-exporting countries have accumulated huge international reserves, while the United States has run a large and persistent current account deficit. Another worry is that inequality appears to have increased in the last two decades in virtually all countries.

This book—based on the international conference on “Winds of Change: The Impact of Globalization on Europe and Asia” held in Kyiv, Ukraine, on March 23–24, 2007 and organized by Warsaw-based CASE-Center for Social and Economic Research and CASE-Ukraine—addresses the growing macroeconomic imbalances and the challenges of globalization and long-term economic growth, with a focus on Europe and Asia. Various aspects of the macroeconomic imbalances are the theme of the first six chapters. The second part of the book discusses how the capitalist model of economic development, which has delivered this growth, is developing or should evolve. The last two chapters consider options available to European policymakers to compete with and adjust to the rapidly growing East Asian Tigers and China.

### Global Imbalances

If properly accounted for, total current account surpluses must be balanced by a sum of corresponding current account deficits. The anomaly of the last decade has been that the United States has become the largest net debtor to the rest of the world economy. Another region that has experienced lasting and sustained current account deficits is Central and Eastern Europe. In chapter 1, Susan Schadler acknowledges that “By conventional standards, the external imbalances of many of the Central and Eastern European countries are indeed large enough to justify serious concerns.” In chapter 2, Alan Ahearne, Birgit Schmitz, and Jürgen von Hagen observe that the current account imbalances in the euro area have widened markedly over the past one-and-a-half decades and that these imbalances have been aggravated since the creation of the Economic and Monetary Union (EMU).

New EU members should expect even larger capital inflows—and current account deficits—when they finally adopt the euro. Marek Dabrowski takes this argument further in chapter 3, where he confronts the traditional framework of analysis for balance of payments with the new realities of a highly integrated world economy with great capital mobility. He proposes an alternative analytical framework that could have far-reaching policy implications.

In chapter 4, Daniel Gros broadens the picture to external imbalances in the world economy. He summarizes three views of the key cause of the excessive global imbalances: Washington blames China for underconsumption and manipulation of its exchange rate in order to promote exports, Europeans complain about the US fiscal deficit and the loose monetary policy of the Federal Reserve, and Asians accuse the United States of overconsumption while themselves seeing a competitive exchange rate as a necessary element of an export-led growth strategy. He concludes that the United States and some European economies have been overheated because of housing inflation, which has been financed internationally—a problem that should be resolved.

In chapter 5 Ray Barrell, Dawn Holland, and Ian Hurst discuss sustainable adjustment of global imbalances. They focus on the US current account deficit of 6 percent of GDP, which has led to a negative US net asset position of 20 percent of GDP. They argue that mere exchange rate changes driven by monetary policy would only temporarily improve the US current account. If a sustained change is to take place, the real economy must change.

In chapter 6, Wing Thye Woo brings China into the discussion. He considers US animosity to Chinese trade surpluses with the United States misdirected. He sees US concern as one of increased job insecurity that derives from both enhanced globalization (not only from trade with China) and rapid technological innovation. Woo finds that the main cause of the Chinese current account surplus is the country's dysfunctional financial system. Total savings exceed investment expenditures, and this savings glut is the cause of the current account surplus. Woo argues that China primarily ought to speed up the renminbi appreciation that started in 2005, not least to contain inflation, accelerate import liberalization, and pursue a more expansionary fiscal policy to soak up excess savings. The United States ought to improve its fiscal balance and reinforce the dwindling Trade Adjustment Assistance program, retraining support, and medical insurance to enhance Americans' sense of security.

### Capitalist Model of Economic Growth

In chapter 7 Leszek Balcerowicz discusses institutional systems and economic growth. He singles out innovation-based growth as potentially lasting and universal, while other forms of growth are merely transitional. Innovation-based growth must be based on a country's institutional system, but it can be blocked by either an information barrier or an incentive barrier. The latter is in effect when the expected utility an individual derives from a new system does not correspond to the utility to society of his or her act. Either investment is hampered or the individual returns of an investment are in danger because of official or private predation. With few exceptions, in countries where incentive barriers prevail, long-term economic growth requires a substantial change of the country's institutions through reform.

In a similar vein, Jacek Rostowski (now minister of finance of Poland) and Bogdan Stacescu consider the impact of the "legal school" versus recent colonial origins on economic growth in chapter 8. Their econometric test fails to verify that a legal system based on the English common law system is more conducive to growth than one founded on French civil law. Instead, their regressions support the view that the problem lies in a wider complex of institutions that are associated with having been a British or a French colony. They find that former British colonies evidence better economic performance than former French colonies.

The last two chapters discuss the possibilities for the European Union to compete and adjust in relation to East Asia's Tigers and China, respectively. In chapter 9, "Does the European Union Emulate the Positive

Features of the East Asian Model?” Anders Åslund arrives at a surprisingly positive answer. In a comparison between key features of the East Asian and EU economic models, he finds that East Asia has excelled in four regards: small transfers and public expenditures, low taxes, freer labor markets, and strong education. He focuses on the first three, which are all prominent goals of the EU Lisbon Agenda of 2000.

In chapter 10, Jean Pisani-Ferry and André Sapir consider the dilemma of relations with China from a European perspective. Their main concerns are that Europe will not reform fast enough to keep up in the competition and could be squeezed in intensified competition between the United States and China, in which the former would be more innovative and the latter more cost effective. A number of factors contribute to the challenges for Europe vis-à-vis China. Chinese integration into the world economy may not help but interfere with European integration. Similarly, Chinese competition may destabilize European privileged trade relations. China’s great demand for energy and other raw materials will boost their prices and affect import-dependent Europe. Dysfunctional European labor markets are a particular handicap. With regard to policies on climate change, Europe and China take opposing positions, which may harm control of greenhouse gas emissions and cause trade disputes. The euro has shot up, while the renminbi is lingering (as a consequence of its continuous peg to the US dollar), further squeezing EU trade. And ultimately, China’s rise in economic power will reduce Europe’s weight not only in the world economy but also in international organizations.

But along with these international shifts and concerns, something curious is happening. Globalization, rather than capitalism, is being questioned because of its huge force that does not seem sufficiently well managed by existing governmental institutions. At the same time, capitalism is developing ever further in most countries. Deregulation and privatization are proceeding in line with the Washington Consensus. Public expenditures are declining and converging. Similarly, democratization is proceeding with economic modernization. The exceptions to this increasing adherence to the rules of normal capitalism are few, essentially some of the most resource-rich countries (such as Russia and Venezuela), which can afford poor economic policies as long as the oil price keeps reaching new peaks.

As the world improves in almost all regards, however, tolerance of the few elements that are not improving—inequality and security—is steadily declining. The economic success of capitalism and globalization may appear to be as good as anybody could have hoped for, but capitalism also has to be politically sustainable.

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